

## SPECIAL REPORT

Troy

# THE FIVE LEVELS OF ASSET PROTECTION PLANNING

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## INTRODUCTION

There are many aspects to asset protection planning. For some persons, asset protection planning can be as simple as relying on state and federal laws that protect certain assets. For others, asset protection planning might involve transferring assets to family members to protect them from creditors. Yet for others, such planning may result in establishing asset protection trusts or captive insurance companies. What level of asset protection planning is recommended will depend on a number of factors, including the nature of the potential debtor's assets, his/her family situation, state of domicile, the degree of exposure to potential claims, and the ability (if any) to adequately insure against potential claims. In this report, the person seeking to protect assets shall be referred to as the "debtor".

## LEVEL ONE STATE AND FEDERAL EXEMPTIONS

The simplest form of asset protection planning is to maximize the debtor's use of state and federal statutory exemptions from collections. Some property may be entirely exempt, while the exemption for other property may be limited to a certain dollar amount. The following asset categories are protected by either the State of Michigan or the federal government.

**Entireties Properties.** Certain kinds of property, if properly titled in the name of a husband and wife together, cannot be reached by the creditors of one spouse alone. Entireties properties include any real estate in Michigan (and the rents therefrom), bonds, certificates of stock, mortgages, promissory notes, debentures and membership interests in limited liability companies. However, joint bank accounts and brokerage accounts are not protected.

**Life Insurance and Annuities.** If the debtor's spouse or children are the beneficiaries of a life insurance policy owned by the debtor, the cash value and the death benefits that are available under the policy are not reachable by the debtor's creditors - even though the debtor has the right to cash in the policy. However, the statute protecting life insurance dates back to 1957 - well before the advent of universal and variable life insurance policies designed partially as investment vehicles. Therefore, it is not clear whether these newer policies are protected by the exemption. Moreover, two cases decided under Michigan law have permitted creditors to attach the

cash values of policies. *Chrysler First Business Credit Corporation v Gary A. Rotenberg*, U.S. District Court, Eastern District, Case No. 91-71274 (Feb. 25, 1992), and *Schenk Boncher & Prasher v Vanderlaan*, No. 237690 (Kent County Circuit Court, LC No. 99-011906CZ). As a result, it may be advisable to have life insurance policies owned by an irrevocable trust (see below). Michigan law also provides a general exemption for annuities purchased for the benefit of any person other than the insured.

**Retirement Plans.** Federal bankruptcy law provides 100% protection for contributions to pension plans, profit-sharing plans, 401(k) plans, 403(b) plans, and Section 457 deferred compensation plans - whether the debtor elects state or federal bankruptcy exemptions. Bankruptcy law also shields assets held in SEP-IRAs, Simple IRAs, traditional IRAs and Roth IRAs. Therefore, an individual can roll assets from a qualified plan to an IRA with full protection from creditors. But the amount of traditional IRA and Roth IRA assets protected is limited to \$1 million (adjusted for inflation). By keeping two separate IRAs, it will be easier to identify IRAs with unlimited protection (rollover) from those subject to the \$1 million limitation (traditional and Roth IRAs).

When funds are withdrawn from a retirement plan, including required minimum distributions, they are no longer protected. In addition, federal bankruptcy law applies specifically to bankruptcy. It does not apply to judgments awarded in state courts. However, in a non-bankruptcy context, Michigan law protects *one* IRA (including a rollover IRA) along with all qualified retirement plans.

## LEVEL TWO LIFETIME GIFTS

If not fraudulently conveyed (see below), assets that are irrevocably gifted to family members are beyond the reach of a debtor's creditors. A gifting program also serves estate planning objectives since the gifted assets (and the income and appreciation thereon) are removed from the debtor's estate and, therefore, will not be subject to estate taxes at the debtor's death. To avoid the federal gift tax, a gifting program typically uses the debtor's \$13,000 (\$26,000 for married couples) annual per donee gift tax exclusion, and \$5 million (\$10 million for married couples) lifetime gift tax exemption for 2011 and 2012.

Under Michigan's Fraudulent Conveyances Act, transfers

for less than full consideration can be set aside by the courts if the transfer was made with the “actual intent to hinder, delay or defraud any creditor of the debtor” *and* renders the debtor insolvent. Therefore, irrevocable lifetime gifts must be made well in advance of any financial troubles of the debtor. The following gifting strategies all assume no fraudulent conveyance occurs.

**Outright Gifts.** Outright irrevocable gifts to family members remove the gifted assets from the reach of the debtor’s creditors. A problem, however, with outright gifts is that the donee is not protected from his/her inability, disability, creditors and predators, including divorced spouses. Another problem with outright gifts is that the debtor loses total control over the gifted property. Accordingly, consideration should be given to making gifts to irrevocable trusts (see below).

Assets transferred to the debtor’s spouse are not subject to gift taxes. However, proper planning is critical to prevent the transferred assets from returning to the debtor-spouse should the donee-spouse die first. Therefore, the donee-spouse should transfer the gifted assets to a revocable living trust designed to provide income and principal for the benefit of the debtor-spouse, but in a manner that protects the trust property from the debtor-spouse’s creditors.

**Irrevocable Trusts.** By making gifts to an irrevocable trust, the debtor can protect his/her beneficiaries from their creditors, including divorced spouses. The debtor cannot be a beneficiary or trustee of the trust. However, if properly designed, the debtor can retain the right to remove and replace trustees (with someone who is not related or subordinate to the debtor). In addition, the trust can give the trustee the power to use trust income or principal for the benefit of the debtor’s spouse. Thus, the debtor will have “indirect” access to trust property .

Leveraging the gifts with life insurance within an irrevocable trust allows the death proceeds to escape estate taxation at the debtor-insured’s death, and (within limits) at the death of the beneficiaries as well. The trust can be designed as a “grantor” trust so that the debtor (as opposed to the trust or its beneficiaries) is taxed on the trust’s income. The debtor’s payment of the trust’s income taxes is the equivalent of a tax-free gift to the beneficiaries of the trust. Moreover, the funds used to pay those income taxes are removed from the reach of creditors.

**Family Limited Liability Companies.** The principal advantages to making gifts of membership interests in a family limited liability company (“FLLC”) are control and flexibility. The debtor transfers to the FLLC those assets to be gifted/protected and then makes gifts of non-voting membership interests to family members (or to trusts for their benefit). As the manager of the FLLC, the debtor has complete power and authority to manage the FLLC’s assets. The non-voting members have no voice in the management of the FLLC, and cannot withdraw their share of the FLLC’s assets without the manager’s consent. Another benefit of making gifts of FLLC membership

interests is that they may be subject to “valuation discounts” for lack of control and marketability, thereby “leveraging” the debtor’s \$13,000 annual gift tax exclusion and \$5,000,000 gift tax exemption.

Under Michigan law, the creditors of a member cannot reach the FLLC’s assets. Instead, a creditor’s sole remedy is a “charging order” which entitles the creditor to any distributions made to the indebted member. However, if the FLLC’s operating agreement is properly designed, the manager has the power to withhold distributions by retaining profits within the FLLC. In such event, the creditor might end up with an income tax liability without the cash distributions to pay the tax. Because of this potential for “phantom income”, the creditor may be willing to settle the claim on a favorable basis with the indebted member.

### LEVEL THREE EQUITY STRIPPING

The concept of equity stripping is simple. The debtor borrows against an asset (i.e., a residence or commercial building) and gives the lender a lien or mortgage on the asset. The loan proceeds are then used to purchase exempt assets (i.e., life insurance and/or annuities), or are gifted to family members either outright, through irrevocable trusts, or through a family limited liability company.

Creditors will stand in line behind a lender who has a “priority lien” on an asset. Because foreclosures are both time consuming and expensive for the creditor, any remaining equity in the asset becomes less attractive for the creditor to chase. In order for equity stripping to work, however, the debtor must have some protected cash flow with which to make the loan payments. If a friendly lender is involved (i.e., the debtor’s spouse, another family member or an irrevocable trust), the lender must pay taxes on the interest. Moreover, the interest payments are not deductible by the debtor-borrower.

**Premium Financing.** An increasingly popular variant of equity stripping is premium financing. This strategy begins with the debtor creating an irrevocable life insurance trust (“ILIT”). The ILIT then borrows the money to pay the premiums on a policy it will own on the debtor’s life. Most lenders will want the debtor to guarantee the loan to the ILIT and will want the guarantee to be backed up with a collateral assignment of the policy and, for example, a lien on real property. In such case, the equity in the real property is stripped. The debtor then makes annual gifts to the ILIT so that the ILIT can make the interest payments.

Normally, the premium loans are for a set term (i.e., five years), at which time they may (or may not) be renewed. In any event, the loan is due at the debtor’s death and can be paid from the death proceeds the ILIT will receive - free of both income and estate taxes. While creditors may be able to get to the asset used as collateral when the loan is repaid, there will be an even greater amount of wealth inside the ILIT that creditors cannot reach. There are no

tax advantages to premium financing since the interest paid will not be tax deductible.

**Accounts Receivable Financing.** Another example of equity stripping is accounts receivable financing. Professionals (i.e., physicians, dentists, accountants, lawyers, etc.) cannot limit their personal liability from malpractice claims – even if they form professional corporations or professional limited liability companies to operate their practices. Moreover, the assets of a practice, including accounts receivable, are subject to the claims of malpractice creditors. One popular way to protect the accounts receivable of a professional practice is for the professional to personally borrow from a bank an amount equal to the practice's accounts receivable. The practice then guarantees the loan and uses the accounts receivable as collateral for the guarantee. The bank then files a lien on the accounts receivable effectively blocking a creditor from attaching them. Afterward, the professional will use the loan proceeds to purchase an exempt asset (i.e., life insurance or an annuity) or will gift the loan proceeds to family members (either outright or through an irrevocable trust or FLLC). Accounts receivable financing has an added benefit beyond asset protection. The transaction can create wealth from an otherwise “stagnant” asset if the tax-deferred growth inside the annuity or life insurance policy, or the after-tax rate of return on the gifted assets, exceeds the interest paid on the loan (which is not tax deductible).

How well equity stripping works depends on the two factors. First, the lower the interest rates and the longer the loan rate is fixed, the better the plan works. Second, if the investments (such as the life policy or annuity) perform well, the better the plan works. Finally, if the loan is made by a family member, then even if the arbitrage between the interest rate and the investment performance turns out to be poor, it makes less economic difference since the interest is being paid to a family member.

## LEVEL FOUR ASSET PROTECTION TRUSTS

While trusts can shield property from the claims of the beneficiaries' creditors, the law is less clear as to whether the trust property can be protected from the grantor's creditors when the grantor is also a beneficiary of the trust. The oldest and most common asset protection trusts are those formed offshore (foreign asset protection trusts). But since 1997, several states have changed their laws to allow for asset protection trusts (domestic asset protection trusts).

**Domestic Asset Protection Trusts.** Several states, most notably Alaska, Delaware and Nevada, have all passed laws protecting assets in a domestic asset protection trust (“DAPT”) from the debtor's creditors. In most states, including Michigan, if a debtor creates an irrevocable trust for his/her own benefit, the assets in that trust remain subject to the claims of the debtor's creditors. In contrast, DAPTs allow a debtor to create a trust for his/her own

benefit, while providing creditor protection for the debtor. Though the laws vary from state to state, most DAPT statutes have the following common features: 1) the transfer to the trust must not violate applicable fraudulent transfer laws; 2) the trust must be irrevocable; 3) the trustee, whether corporate or individual, must be a resident of the state in which the trust is formed; 4) some trust assets must be located or deposited in the DAPT state; and 5) the trust agreement must contain a “spendthrift” clause which restricts the transferability of a beneficiary's interest in the trust property. Moreover, each DAPT state has provisions allowing creditors a time period to make claims against the DAPT and requiring that the individual remain personally solvent after the transfer.

It is important to note that DAPT statutes are relatively new and have not been exposed to rigorous court challenges. Although DAPT statutes appear to offer substantial asset protection, DAPT jurisdictions cannot be as protective a site for establishing trusts as an offshore jurisdiction (see below). The reason is that they are part of the United States and, therefore, are bound by the U.S. Constitution. By virtue of the “full faith and credit” mandate in the Constitution, a DAPT state's courts should be required to enforce judgments rendered against its own citizens under the laws of less debtor-friendly, non-DAPT states like Michigan. Whether they will remain to be seen.

The 2005 changes to the Bankruptcy Code have created a new 10-year limitation period for transfers to DAPTs when made with the “actual intent” to hinder, delay or defraud present or future creditors. This effectively means that all transfers to DAPTs will be suspect for the 10 years prior to the date that a bankruptcy petition is filed. Because of this 10 year statute of limitations, and because of the potential Constitutional challenges a DAPT may face, DAPTs are viewed by many advisors as a “poor cousin” to a foreign asset protection trust.

**Foreign Asset Protection Trusts.** Foreign asset protection trusts (“FAPTs”) are carefully designed trusts formed under the laws of a foreign jurisdiction to take advantage of local statutes favoring debtors. The Cook Islands, Cayman Islands, Bahamas, Belize and Nevis are very favorable jurisdictions for FAPTs. Although more expensive to establish and administer than a DAPT, FAPTs are considered by many advisors to be the ultimate asset protection trust.

Properly structured, a FAPT allows the debtor to put assets beyond the reach of creditors and U.S. judgments, while allowing the debtor access to the assets held by the FAPT. The jurisdictions mentioned above do not honor foreign judgments, thereby requiring a creditor to retry the case in the foreign jurisdiction. Moreover, the applicable fraudulent conveyance laws in those jurisdictions require “proof beyond a reasonable doubt” that the trust was established to defraud creditors and, generally, have short statutes of limitations (i.e., two or three years). Thus, the barriers to bringing an action in a foreign jurisdiction are formidable for all but the most determined and well

financed creditors. Since the debtor is usually a beneficiary of the FAPT, the debtor is taxed on all of the trust income. Therefore, no income tax savings are afforded by FAPTs. However, the jurisdictions referred to above do not impose any local taxes on trust income.

One of the more popular ways to take advantage of a FAPT is for the debtor to transfer his/her assets to a limited liability company. The debtor would retain a 1% voting membership interest and would serve as the manager of the LLC. The other 99% non-voting membership interests would be transferred to the FAPT. The assets do not leave the U.S. until the debtor is actually threatened, at which time the LLC is dissolved and 99% of the LLC's assets are transferred to the foreign trustee of the FAPT.

## LEVEL FIVE CAPTIVE INSURANCE COMPANIES

Certainly the best form of asset protection for a business owner is to insure the risk with a commercial carrier. However, the cost of insurance is often prohibitive. Moreover, coverage for certain types of risks may not even be offered by commercial carriers. Therefore, self-insurance is quite common. For example, many physicians find it economically unreasonable to purchase adequate malpractice insurance coverage. Thus, they take on some or all of the risk rather than pay insurance premiums. In such event the physician is self-insuring for that risk whether he/she realizes it or not. A captive insurance company ("CIC") allows for a debtor to reserve for these self-insured risks in a tax-advantaged way.

**Structure.** A CIC is essentially a private insurance company that writes limited risks, generally those of its owners. A CIC only insures the risks its owners want it to take, and none others. Most often, a CIC is a form of self-insurance for minor risks, with catastrophic losses covered by means of reinsurance from a commercial carrier. CICs have direct access to commercial insurance underwriters and enjoy substantial discounts and credits often based on the insured's history rather than industry standards. CICs may be formed in certain states. However, they are more typically formed in an offshore jurisdiction, such as Bermuda or the British Virgin Islands, because of more favorable insurance laws and tax treatment. Funds owned by the offshore CIC can still be maintained and managed in the United States. Set-up costs for CICs range between \$50,000 and \$250,000, and annual compliance costs between \$15,000 and \$35,000.

**Benefits.** A CIC allows the debtor to custom-tailor the insurance to fit the debtor's needs, and to include or exclude certain risks as desired. For example, a physician might use a CIC to supplement his/her traditional malpractice coverage in order to have a larger deductible or to lower the limits, thereby reducing the premiums. Coverage can also be provided for liabilities usually not offered by traditional carriers, such as wrongful hiring/firing, economic losses, HCFAs or HIPAA violations, or losses due to terrorism or governmental action (such as

changes in environmental laws). Another type of coverage that can be provided is for litigation expenses (i.e., attorney fees, expert witness expenses, etc.). Such coverage is particularly helpful for a business exposed to frivolous claims where the likelihood of the plaintiff prevailing is low, but the defense costs are high.

Another benefit to a CIC is that it allows the debtor to resolve his/her own claims. The debtor can decide to settle early on in the judicial process, or to refuse to settle if that is in the debtor's best interest. It also allows the debtor to choose his/her own attorneys to defend the lawsuit as opposed to those attorneys selected by the insurance company. In short, a CIC allows the debtor to have substantial control over the litigation process.

**Taxation.** Under Internal Revenue code Section 831(b) a CIC with net premium income of less than \$1.2 million annually may elect to be taxed only on its investment income. Thus, the premiums are tax deductible to the business, but free of federal income tax to the CIC. The CIC's investment income is taxed at C-Corporation rates. But if the CIC invests a portion of its assets in a life insurance policy, the investment income can be reduced. At retirement (and when creditor free) the debtor can close down the CIC, take the money out and only pay capital gains taxes (currently 15%).

In order for the premiums to be fully deductible, an actuarial firm must determine the premiums and reserves required based upon the types of risk to be undertaken and the levels of risk to be assumed by the CIC as compared to the reinsurer. If the premiums paid are actuarially sound, there should be no risk of a fraudulent transfer. Moreover, when a debtor self-insures, the funds stay in his/her name (or in the name of the business). Thus, the funds are readily attachable by creditors. In contrast, the funds in the CIC are separate from the debtor and, therefore, protected.

**Wealth Transfer.** By having all or a portion of the CIC owned by the debtor's children, grandchildren and/or trusts for their benefit, substantial wealth can be transferred free of estate taxes! Another benefit of a CIC is that it permits a debtor to transfer value out of his/her business in a legitimate and tax efficient manner. And wealth that would have otherwise been accumulated in the business or distributed to the debtor is removed from the reach of creditors. Finally, the CIC can invest in the debtor's related businesses and/or in new business ventures, and may function as a secured lender to strip equity from the debtor's unprotected assets (see Level Three).

In summary, a CIC is one of the best risk management, asset protection and wealth transfer tools available for professionals and business owners, but it does not come without significant responsibilities and costs.

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